

# CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 425

December 5, 1984

## TAXATION OF CALIFORNIA STRS FAMILY ALLOWANCE BENEFITS

### Syllabus:

Issue 1: When paid as an annuity, is any portion of an STRS family allowance includible in the gross income of the recipient beneficiaries?

Answer: Yes. To the extent distributions exceed consideration for the annuity, the family allowance is includible in the gross income of the recipient beneficiaries.

Issue 2: When paid as a lump-sum distribution of the decedent's accumulated contributions, plus interest, is any portion of an STRS family allowance includible in the gross income of the recipient beneficiaries?

Answer: Yes. The allowance in lump-sum form is to be taxed as a lump-sum distribution from a qualified plan.

### Discussion;

#### A) General description of STRS benefits.

STRS is a contributory, defined benefit retirement plan established by the State of California for public school teachers. (Ed. Code § 22001.) Participants are eligible for basic retirement benefits after completing five years of credited service time and after attaining the age of 55. (Ed. Code § 23901.) Basic retirement benefits are based on the participant's total years of credited service time and highest average compensation for any three years. (Ed. Code § 24000.)

#### B) Description of the family allowance benefit.

Sections 23804-23815 of the Education Code provide a family allowance benefit to survivors of an STRS participant who dies before becoming eligible to receive a retirement benefit. Additional requirements are that the decedent must have completed one year of credited service time, must have made all mandatory contributions, must not have specified another retirement death benefit option, and must be survived by persons eligible to receive the allowance (close relatives, generally). The amount and the form of the allowance can vary according to the number and the identity of the recipient beneficiaries. Basically, the family allowance is payable in the form of an annuity; however,

if the recipient beneficiary is a spouse or parent of the decedent, they may elect to receive their benefit in the form of a lump-sum return of the accumulated contributions and interest. /1

(a) Spouse and one child or more; maximum benefit is 90 percent of decedent's final compensation. If survivors consist of a spouse who is financially responsible for at least one minor child, the spouse is paid, in monthly installments, 40 percent of the decedent's final compensation plus 10 percent for each minor child up to a maximum of 90 percent of the decedent's final compensation. These payments continued for so long as the widow is unmarried and each dependent child is below 18 (22 if a fulltime student). Under Ed. Code § 23804.5, their payments are reduced by any other amount received from other public benefit programs by reason of the decedent's death.

(b) Minor children only; maximum benefit is 10 percent of decedent's final compensation per child up to 50 percent. If the decedent is survived only by dependent minor children, each child is paid, in monthly installments, 10 percent of the decedent's final compensation up to a maximum combined amount of 50 percent until the age of 18 (22 if a full-time student). If there are more than five children, the 50 percent maximum benefit is divided among them equally.

(c) Spouse only; benefit is either 1) lump-sum distribution of accumulated contribution, plus interest, or 2) life-time conditional annuity. If the decedent is survived by a spouse only, the spouse can elect to receive an immediate distribution of the decedent's accumulated contributions, plus interest (see (a) or (e)), or elect to receive, provided she or he remains unmarried at age 60, an annuity equal to one-half the benefits the decedent would have been entitled to receive had the decedent retired at age 60.

(d) Dependent parents only; benefit is either 1) lump-sum distribution (see (e)) of accumulated contributions, plus interest, or 2) life-time conditional annuity. If the decedent is survived only by dependent parent(s), such parent(s) is entitled to the same options as specified in (c), above. However, the annuity option is not conditioned on the marital status of the parents.

(e) Special Option: only for surviving spouse or surviving dependent parent; immediate lump-sum return of decedent's accumulated contribution, plus interest. Provided there are no surviving children, a surviving spouse or dependent parent can elect to receive an immediate distribution of the decedent's accumulated contributions and interest, provided such election is made prior to the first payment of the annuity option in (c) and (d).

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/1 Ed. Code § 23804.3 lists the potential recipient beneficiaries and their allowances in the following order of priority:

The return of the decedent's accumulated contributions is guaranteed. If the recipient beneficiary elects payment in the form of an annuity, and later chooses to terminate the annuity, the designated beneficiary will receive the decedent's undistributed contribution, plus interest. (Ed. Code § 23807) And, if the decedent is not survived by a party eligible to receive a family allowance, accumulated contributions, plus interest, are paid to his/her estate. (Ed. Code § 23801)

C) Taxation of the family allowance.

(1) As an annuity.

Rev. and Tax. Code § 17131 incorporates by reference IRC §§ 101(a) and 101(b). IRC § 101(a) provides for an exclusion from gross income of amounts paid under a life insurance contract by reason of the death of the insured. IRC § 101(b) provides for an exclusion from gross income of up to \$5,000.00 for amounts paid to the beneficiary or estate of a deceased employee by or on behalf of his or her employer if such amounts are paid solely by reason of the death of the employee. A distribution or payment does not qualify for the limited death benefit exclusion if the employee possessed, immediately before death, a nonforfeitable right to receive the payment while living.

Under options a, b, c, and d, above, the family allowance is paid in annuity form for a temporary conditional period, or for life, as the case may be. As death is the event triggering payment of an allowance, the payments are either life insurance proceeds or they are employee death benefits.

It is well established that a contract of life insurance need not be in the form of a standard life insurance contract in order to qualify for the life insurance exclusion. (Mary Tighe v. Cir., 33 T.C. 553, 564 (1959); Estate of Benton Louis Snyder, 4 TCM 957 (1945).) Although the contract need not be in the traditional form, there must be a binding arrangement involving risk shifting and risk distributing. (Helvering v. LeGierse, 312 U.S. 531, 539 (1949); Estate of Barr, 104 Cal.App.2d 506, 508-509 (1951).) The general holding in the federal courts is that indefinite survivor benefits paid by a state or local government do not constitute life insurance proceeds. (Davis v. United States, 323 F.Supp 858 (1971); Laura v. Lilly, 45 T.C. 168 (1965); Essenfeld v. Cir., 311 F.2d 208 (1962).) In a number of these decisions, it was found that, absent a definite benefit payable upon the death of an employee, there is no shifting of risk in any meaningful sense and therefore such a plan does not constitute a life insurance arrangement.

The family allowance is an indefinite survivor benefit and therefore cannot be deemed life insurance proceeds. Amounts exceeding the decedent's contributions are payable only if the decedent is survived by persons eligible to receive an allowance, i.e., a spouse, dependent children, or dependent parents. Moreover, at the employee's death, nothing is returned exceeding the

decedent's accumulated contributions. Therefore, there is no shifting of risk in any meaningful sense. The instant case is distinguished from the decision of the U.S. Court of Appeals, Fifth Circuit, in *Ross v. Odom*, 401 F.2d 404 (CA-5 1968), where the court found that proceeds from a self-insured state death benefit program which provided a definite benefit constituted life insurance proceeds.

In contrast, the family allowance in this form has all of the attributes of an IRC § 101(b) employee death benefit payable as an annuity. The decedent does not have a nonforfeitable right to receive amounts exceeding the accumulated employee contributions, plus interest. And the allowances, which are established with the decedent's contributions of tax-paid dollars, satisfy the test for "amounts received as an annuity" under Treas. Reg. § 1.72-4(b)(2):

- (i) Allowances are received on or after an annuity starting date;
- (ii) Allowances are payable in periodic installments at regular intervals over a period of more than one full year from the annuity starting date; and
- (iii) The total of the amounts payable are determinable at the annuity starting date from the terms of the contract, through actuarial computation, or both.

(See also *Anna E. Curtis v. CIR*, 8 T.C. 266, 272 (1947); Treas. Reg. 1.101(d)(2), ex.2.) Thus, the allowance is an employee death benefit payable as an annuity and is subject to exclusion from the recipient beneficiary's gross income up to \$5,000.00.

The taxation of an employee death benefit payable as an annuity is accomplished under the following rules. Rev. and Tax. Code § 17081 incorporates by reference the federal annuity provisions at IRC §§ 71-72(h). To the extent amounts received constitute consideration for the annuity, the allowance is excludible from the gross income of the recipient (Treas. Reg. § 1.71-1(a)). Where a death benefit is payable as an annuity, the amount of the death benefit subject to exclusion (\$5,000.00) shall be treated as additional consideration paid by the employee. (IRC 101(b)(2)(D).) The amount of death benefit subject to exclusion is the amount by which the present value of the annuity to be paid the beneficiary, computed as of the date of the employee's death, exceeds the value of the larger of the employee's contribution or amounts the employee possessed a nonforfeitable right to receive during life, or amounts in lieu thereof. (Treas. Reg. § 1.101-2(e)(1)(iii).) Reference is made to the actuarial tables at paragraph (f) of § 20.2031-7 of the estate tax regulations as the starting point for computing present value. Appropriate actuarial tables must be used in calculating present value. Once established, the total cost of the annuity is to be prorated over the term of the annuity. (Treas. Reg. 1.72-1(c).) This proration is accomplished by means of an exclusion ratio which is computed by dividing the employee's cost investment by the total expected

return under the contract as of the annuity starting date. (IRC§ 72 (b), Treas. Reg. 1.72-4(a).) If more than one annuity is acquired for a single consideration, an exclusion ratio is determined for the contract as a whole and applied to each annuity. (Treas. Reg. 1.72-4(e)(1).) In computing the expected return annually, factors compensating for other contingencies, viz., marriage or loss of student status will not be considered. (Rev.Rul. 68-293, 1968-1 C.B. 43; Rev.Rul. 70-490, 1970-2 C.B. 11; Rev.Rul. 72-80, 1972-1 C.B.55.) If the expected aggregate annuity payments for the first three years, however, exceed the employee's cost, all payments are excluded from gross income until the amount of such cost has been recovered. (IRC § 72(d).) This is the so-called "three-year recovery rule."

(2) As a lump-sum distribution.

The portion of the accumulated contributions distribution in excess of the decedent's actual contribution is taxable as a lump-sum distribution from a qualified plan. (See Rev.Rul. 68-456, 1968-2 C.B. 184.) An option (e) distribution satisfies the lump-sum requirements of IRC § 402(e)(4)(A) (incorporated by Rev. & Tax. Code § 17501). It is paid by reason of the death of an employee within one taxable year of the recipient and consists of the balance of the credits to the account of the employee. The death benefit basis adjustment does not apply to the distributions of accumulated contributions and interest as the decedent possessed a nonforfeitable right to receive this distribution during life.